United States Court of Appeals

for the Second Circuit

APPELLANT'S REPLY BRIEF

76-4170

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

DOCKET NO. 76-4170

EDWARD M. GILBERT,

Appellant,

- against -

COMMISSIONER OF INTERNAL REVENUE,

Appellee.

ON APPEAL FROM THE UNITED STATES TAX COURT

REPLY BRIEF ON BEHALF OF APPELLANT

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CITATIONS

POINT I

THE GOVERNMENT'S STATEMENT OF THE LEGAL PRINCIPLE OF JAMES IS ERRONEOUS.

The Government has interpreted James v. United States, 366 U.S. 213 (1961) in the most restrictive manner possible. The Government focuses upon Gilbert's first argument which is based upon the limiting language in James to the effect that where funds are acquired with a "consensual recognition . . . of an obligation to repay . . ." the recipient does not realize taxable income. 366 U.S. at 219. The Government's position is that where an embezzlement is involved, this act ". . . excludes any possibility of such 'consensual recognition', and that this reference in James solely applies to transactions qualifying as loans." (Br. 16-17). Assuming its interpretation to be correct, the Government then goes on to point out that a loan arrangement involves a "contract" between parties and that an embezzlement does not by its very nature involve any contractual arrangement. (Br. 17-18).

The Government's position is apparently based upon language found in the James case to the effect that the test set forth ". . . brings wrongful appropriations within the broad sweep of 'gross income'; it excludes loans." 366 U.S. at 219. This language follows a reference by the Court in James to the claim of right doctrine as being a basis upon which to realize income, and to the situation where a taxpayer has the "actual command" over property (thus deriving an economic benefit from such property) as a further basis for the realization of income. These concepts, taken together, form a broad foundation for the realization of income for property received, either lawfully or unlawfully.

The Government's position, therefore, requires that the language in the James case, referring to consensual recognition, express or implied, of an obligation to repay, be confined to situations involving a loan (which, incidentally, the Court in James cites as but one example of the meaning of "consensual recognition"). Since a loan and embezzlement are mutually exclusive concepts, an embezzlement can never fall within the limiting language of the James case, according to the Government.

Although the Government in this case asks the Court to ignore the limiting language of the James case in any situation involving an unauthorized or unlawful acquisition of funds, the Government has not always taken that position. In Buff v. Commissioner, 496 F.2d 847 (2d Cir. 1974) the Government recognized that there might be a situation where an embezzler did not realize earnings, where there was a consensual recognition, express or implied, of an obligation to repay. In the Buff case, the Government, in its second argument, appears to have advanced the position that a consensual recognition had to occur at time of receipt rather than at the end of the pertinent accounting period for the exception in James to apply. 496 F.2d 848. In contrast, the Government states in the instant case that there can never be a consensual recognition in a case where funds are withdrawn without proper authority because the "victim" is unaware (Br. 18). Undoubtedly, this position is now advanced because Gilbert would have satisfied the standards applied for consensual recognition by the Government in the Buff case in its appeal of that case to this Court. (See Gilbert's Main Br. 20, footnote).

The limiting language in the James case conceivably can apply to situations involving loans, at one extreme, and situations involving the surreptitious, unauthorized withdrawal of funds or property, where there is a discovery of the unauthorized taking after the fact, at the other extreme.

It seems clear that a loan between parties does not involve taxable income. The point is so obvious that, if the Court in James had meant to confine its limitation only to loans, it would have said so. It seems equally clear that the Court in James anticipated that some situations might arise, not involving mere loans, where because of the particular circumstances, the unauthorized withdrawals might not be regarded as income because of a consensual recognition of the obligation on the part of the party withdrawing funds to make a repayment in full. As set forth in Gilbert's main brief, we believe that the unique circumstances of this case should fall within the limiting language of the Jame case.

As pointed out in Gilbert's main brief, Gilbert was promoting a combination between E.L. Bruce Co, Inc., ("Bruce") and Celotex Corporation ("Celotex"), and had acquired a substantial position in Celotex shares, which he

had offered to Bruce at Gilbert's cost in order to implement the proposed acquisition. Gilbert directed the unauthorized withdrawals from Bruce to cover margin calls on his Celotex stock. Although he would have remained personally obligated in any event to restore the funds withdrawn from Bruce in order to cover his margin calls it should be noted that Bruce at all times could have acquired Gilbert's Celotex stock even though that stock had risen in value substantially over his cost. Therefore, while there was a benefit to Gilbert in using the funds withdrawn without proper authority, there was also a benefit to Bruce.

It is Gilbert's position in this case that there was a consensual recognition at the time of the taking by Gilbert of his obligation to repay Bruce for the wrongfully withdrawn funds and that Bruce within the context of the same time period also reached the same arrangement with Gilbert. Because of this, Gilbert believes it is unnecessary to take the further position that his consensual recognition at the time of the taking of an obligation to repay the funds wrongfully withdrawn is sufficient without the participation of Bruce in that consensual recognition to have the facts of this case fall within the limiting language of the James case.

It was Gilbert's uncontradicted testimony at trial that he at all times recognized his obligation to repay the wrongfully withdrawn funds (Tr. 63; R. 29a)*. His subsequent actions bore this out (Main Br. 17, 18). Bruce also recognized Gilbert's obligation to repay. This recognition was evident at the June 12, 1962, meeting of the Board of Directors of Bruce. Although the unauthorized withdrawals were never ratified by the Board of Directors of Bruce, there was a prompt and evident confirmation of the arrangement by which Gilbert was obliged to repay the funds withdrawn from Bruce without proper authority.

Counsel for Bruce was promptly informed of the unauthorized withdrawals by Gilbert. Gilbert also began informing various Directors and a special meeting was called at which the full Board was notified. Prior to this meeting, Gilbert had already executed notes and an assignment fully covering the amount of the withdrawals.

The Government's brief states that "it is evident that not more than two of Bruce Co.'s Directors . . ." were informed by Gilbert prior to June 11, 1962 (Br. 22). Gilbert testified that he had informed at least six (6) Directors immediately after the withdrawals, naming one to be his father, Harry Gilbert, and two others as Henry Loeb and

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*"R." references are to the separately bound record appendix.

Frank O'Connor (Tr. 66; R. 32a). The Government claims this must be false because another Director, Harvey Creech, testified that he had no knowledge prior to June 11, 1962. The apparent logic of the Government's reasoning is that, since both Mr. Creech and Mr. O'Connor were members of the Memphis contingent of Directors, Gilbert must be incorrect in his testimony, since one Memphis Director would undoubtedly tell another. The Tax Court made no such findings to this effect.

Gilbert also testified that, of the Directors informed, at least half agreed to approve the withdrawals at the upcoming special meeting. The Government claims that the record of that meeting refutes this claim (Br. 23). However, the Directors at that meeting were asked whether they had prior knowledge of Gilbert's intent to make withdrawals before they were made and, if so, whether they approved of such withdrawals (Ex. 5-E; R. 82a). There is no evidence of record to contradict Gilbert's assertion that he had informed various Directors after the withdrawals and that they had agreed to support him at the special meeting.

The Government's brief, in the instant case, analyzes anew the Buff case in some depth. Regardless of

the Government's present view of the Buff case, Gilbert meets all of the three arguments raised by the Government and the dissenting opinions of the Tax Court as set forth by this Court in that case (Main Br. 20, footnote). It should also be noted that Gilbert meets the conditions of United States v. Merrill, 211 F.2d 297 (9th Cir. 1954), although it is believed that Gilbert does not need to rely on that case.

POINT II

THE INTERNAL REVENUE SERVICE PREVENTED GILBERT FROM MAKING A REPAYMENT IN 1962 OF THE FUNDS WITHDRAWN FROM BRUCE

Gilbert assigned all of his assets to Bruce, using a secured note. The Court below found that the fair market value of the assignment on June 8, and June 12, 1962, exceeded $1,953,000, the net amount of Gilbert's unauthorized withdrawals of funds from Bruce. However, Bruce did not properly record the assignment, and when the Government subsequently made a jeopardy assessment against Gilbert, and filed its notices of federal tax lien, the Government perfected its federal tax claim ahead of the secured claim of Bruce for the assets of Gilbert. The competing claims could not possibly have been satisfied from the assets available.

Gilbert has argued that the Government interrupted an arrangement between Gilbert and Bruce by which Gilbert would have made a full repayment, or a substantial repayment, of the wrongfully withdrawn funds to Bruce by the conclusion of 1962. Gilbert cited the case of Ray S. Robinson 44 T.C. 20 (1965), which held that there could be no constructive receipt of income in the situation where the federal Government, following a jeopardy assessment, served a notice of levy upon the source of the funds upon which constructive receipt of income would have been based.

Without commenting on the record with regard to the Robinson case, the Government contends that it is misleading to fault the Government for filing its tax claims under the circumstances of this case. The Government argues that Gilbert, not the Government, caused the jeopardy assessment to be made. On this basis, the Government contends that Gilbert, not the Government, was the party at fault, and that, therefore, the effects of the jeopardy assessment (preventing the implementation of the arrangement between Gilbert and Bruce to restore the wrongfully withdrawn funds) should be ignored.

However, it should be noted that in the Robinson case the taxpayer caused the jeopardy assessment to be

made against him, and also caused a notice of levy to be served upon the source of the funds upon which the taxpayer's constructive receipt was purportedly based. Both the Tax Court and the taxpayer in the Robinson case ignored the cause of the jeopardy assessment (i.e., the taxpayer's conduct), and instead looked to the effect of such a jeopardy assessment upon the receipt of income. We believe the same rationale should be followed in this case with respect to the availability of a deduction.

The Government also asserts that Gilbert, when he returned from Brazil in November of 1962 could have caused the Internal Revenue Service to remove its liens, and to abate its jeopardy assessment, releasing Gilbert's assets for liquidation and the repayment of his financial liability to Bruce, (and thereby permitting a tax deduction to the extent of such a payment). However, we respectfully submit that the Government perhaps is not aware of the difficulties that a taxpayer encounters in having either a jeopardy assessment abated, or in having a notice of federal tax lien removed from the public records. Truly, this contention stretches the limits of credibility. The testimony of Bruce's attorney, Thomas Field, gives ample evidence of the difficulties in dealing with the Government, when a party is faced with a tax lien which is prior in time and therefore prior in right to any other interest involved.

The Government also points out in its brief that the dissent in the James case was concerned with the hardship of the victim, but that this obviously was not persuasive to the majority of the Court in the James case. While Gilbert took note of this hardship in his main brief, it is not the basis of his position in this case. It is manifest from the facts of this case that any repayment by Gilbert in 1962 of the funds wrongfully withdrawn by him from Bruce would have been impossible because the Government effectively interrupted the process already under way to achieve that result. The Government's successful effort to secure its federal tax liens should not interfere with the determination of taxable income through all available deductions. It is the hardship and the basic unfairness, resulting from the Government's jeopardy assessment in the context of the facts of this case to which Gilbert's main brief is addressed.

Respectfully submitted,

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